



Good morning, my name is Mark Wayne. I am the President of Freedom One Investment Advisers. Freedom One is an investment consultant and plan fiduciary to hundreds of 401(k) plan sponsors. Each year, Freedom One performs over 10,000 individual one-on-one retirement planning sessions with 401(k) participants. Freedom One Retirement Services is an independent, full service 401(k) plan administrator and recordkeeper with over 400 clients, representing over 30,000 401(k) participants. Our firm has been evaluating and recommending various target fund arrangements for over ten years.

I am here on behalf of the National Association of Independent Retirement Plan Advisors ("NAIRPA"). NAIRPA is a national organization of firms which provide independent investment advice to retirement plans and their participants. NAIRPA's members are registered investment advisors whose fees for investment advisory services do not vary with the investment options selected by the plan or participants. In addition, NAIRPA members commit to disclosing expected fees in advance of an engagement, reporting fees annually thereafter, and agreeing to serve as a plan fiduciary with respect to all plans for which a member serves as a retirement plan advisor.

Today, I would like to discuss how Target Date Funds ("TDF's") are being used as investments in 401(k) plans. I would like to share my experiences in how TDF asset allocation strategies, and the associated risks, are being communicated to plan sponsors and their participants and ways this process could be improved. I will also discuss the benefit of review by an independent investment expert on a particular plan's TDF investment performance. I will close with a proposal to improve the use of TDF's as Qualified Default Investment Alternatives (QDIA's).

In my work, I meet with plan sponsors on a regular basis. Target date retirement funds, although relatively new, are growing in popularity. The Department of Labor's regulation sanctioning the use of TDF's as an acceptable QDIA has been a significant driver in their expansion. I would estimate that 90% of the 401(k) plans that I work with include TDF's as an investment alternative and over 80% of the assets in those plans are invested in various TDF products.

Why have TDF's become so popular? There are a number of reasons but chief among them is their simplicity. Conventional investment theory suggests that a participant's mix of investments should grow more conservative as the participant gets closer to his or her retirement. This result can be achieved through periodic "rebalancing" of the investments in the participant's account. However, many participants do not actively manage their accounts and as a result have less than ideal asset allocations.

TDF's provide an easy solution to this problem by automatically rebalancing the fund's asset allocation to become more conservative over time. This should result in a rate of return and risk that is appropriate for the investor as he or she grows older. Participants are attracted to TDF's because they are an easy alternative to the many, sometimes bewildering, investment choices offered in a typical 401(k) plan.



TDF's allow for the "set and forget" approach to investing. Although not ideal, TDF's are a good choice for participants who are unwilling or unable to manage their own investments.

NAIRPA strongly agrees with the concept and theory behind offering TDF's as 401(k) investments. For most participants, it is the most easily accessed mechanism to ensure the participant has an appropriate investment selection and their investment portfolio is rebalanced on an on-going basis. However, my experience has shown that there are some significant problems with how TDF's are presently marketed. In particular, what is lacking is clear and understandable information on the TDF's investment strategy and the potential risks associated with that strategy.

The experience of our members is that TDF prospectuses for major mutual fund families generally describe the fund's investment objectives as simply to "...provide capital appreciation and current income consistent with its current asset allocation."<sup>1</sup> This wording, which comes from a Vanguard prospectus, is used to describe the investment objective for the mutual fund family's target date funds. These funds range from a 2005 fund through to the 2050 fund. Similar language can be found in the prospectuses for TDF's offered by ING, Schwab, Alliance Bernstein and others. Here is our concern, the 2050 fund might be invested 99% in equities and the 2005 fund might be only 1% in equities. Plan fiduciaries and unsophisticated plan participants need a clearer, more understandable description of how the fund invests and the investment risks that are associated with the fund's investment strategy. Only then will it be possible for participants to clearly understand the different asset allocation strategies employed by different TDF's.

We believe that communications could be greatly improved by a "truth-in-labeling" approach to how TDF's are sold and marketed. Although most TDF's do have a nominal target date, there are wide differences in what that date really means. For example, the prospectuses for many TDF's simply say that the fund's investment strategy is designed for someone who is retiring in or within a few years of the target date. What is not clear is whether this means the investment strategy assumes the investor will need a lump sum liquidation distribution from the TDF at that time or instead will begin to draw down the investment through periodic withdrawals over their retirement years. The difference in these two time periods could be as much as thirty years.

We believe that for plan fiduciaries to fulfill their responsibilities and for participants to understand their alternatives, there must be new, plain English disclosures of how the TDF invests, and what that means to the average, unsophisticated 401(k) investor. Merely providing the prospectus information required under current securities law is not enough, as evidenced by the communication practices used today. There is widespread confusion as to what the "target date" really means for any particular TDF. We believe there must be consistent standard. Although we don't believe there should be a mandatory mix of investments, nevertheless, fund managers should disclose in plain English what the "landing point"

---

<sup>1</sup> Vanguard Target Retirement Funds Prospectus, January 28, 2009



will be for their TDF's glidepath. In other words, at what point does the fund no longer need to be rebalanced because it has reached the appropriate mix of stocks, bonds and cash? With this information, plan sponsors will be in a better position to make an "apples-to-apples" comparison between TDF providers.

Another concern we have in regard to the use of TDF's in 401(k) plans is the potential conflict that arises when a TDF is constructed as a "fund-of-funds", particularly when constructed using only proprietary funds of the fund manager. The concern is that the fund manager has conflicting loyalties. On one hand, there is a desire to achieve performance results that makes the TDF attractive to investors. On the other hand, when proprietary funds are used as the sole basis for constructing the TDF, the fund manager may be forced to use a lower rated proprietary fund rather than a higher rated, unaffiliated investment. We do not believe there is anything inherently wrong with using proprietary funds to construct the TDF. However, our experience has shown that investment performance significantly improves if an independent investment manager is retained to review the TDF program and recommend changes if warranted. For example, consider an environment where two TDF's funds with the identical retirement year were made available to participants, with the identical asset allocation between stocks and bonds. Further consider that one TDF was constructed solely of one fund family's proprietary funds and the other TDF was constructed using only the top rated funds from several fund companies. There would be a very high probability that the TDF constructed only of top rated funds from several different mutual funds families would provide a much better return than the TDF constructed of only the mutual fund's own proprietary funds.

Let me tell you about a recent experience I had in meeting with a plan sponsor. This Michigan employer sponsored a 401(k) plan with nearly 5000 participants and over \$220 million in assets. For many years, the plan sponsor had been hiring independent retirement plan advisors and employing a sophisticated process to ensure only high quality mutual funds from various fund companies were offered as 401(k) investment alternatives. With the assistance of an independent retirement plan advisor, the plan sponsor's investment committee carefully researched current and potential investment options as they decided which options would remain in the plan and which needed to be replaced. As a result, the available investments contained only top quality, low cost investment options.

Several years ago, the plan sponsor determined that their employees were not doing a very good job in allocating their assets among the plan's investment options. This primarily resulted from the lack of investment sophistication of the plan participants. We have found this to be a common problem in nearly every 401(k) plan we work with. As a result, the plan sponsor looked to the mutual fund company that was already providing many of the funds, as well as the recordkeeping services for the plan, and requested if TDF'S were available. The TDF option that was available was the mutual fund's own TDF, constructed as a "fund-of-funds" using their proprietary products. The plan decided to include the mutual fund family's TDF's as both a QDIA and an investment alternative that participants could



affirmatively select. In addition, the plan sponsor allowed the mutual fund company to heavily promote the new TDF offering. Within twelve months, over 35%, or nearly \$100 million, was invested in the mutual fund family's TDF's.

Freedom One, an independent retirement plan advisor, was asked to perform an evaluation of all the mutual funds being offered as investment alternatives. The vast majority of the funds in the menu were logical and competitive choices to offer to the employees. During our discussions, the plan sponsor described to us the process by which they had evaluated various funds over the years and replaced those that were underperforming as measured against their peers. The sponsor was clearly proud of how much better off the participants were as a result the process they had employed.

We then turned to the TDF's, which as I mentioned, were constructed as "funds-of-funds". As it turned out, the underlying proprietary funds that made up the TDF were largely made up of the very funds that had previously been removed by the plan sponsor because they were underperformers. Yet because these funds were the only funds used by the TDF, participants who wanted the benefit of automatic rebalancing were forced to invest in inferior funds. The plan sponsor had been completely unaware of this issue until we raised it based upon our independent review.

I would like to close with a recommendation on how to improve the use of TDF's in the context of a 401(k) plan's default investment program. Under the QDIA regulation, an investment fund can qualify as a QDIA only if the fund is managed by an ERISA (3)(38) manager or trustee, or by a named fiduciary of the plan. However, mutual funds are exempted from this requirement. As a result, the mutual fund is *not* required to assume any fiduciary responsibility for the investment decisions made with regard to the fund's asset allocation, the funds uses as in the allocation, or it's "glidepath" strategy.

We believe the QDIA regulations must be changed to provide, that in the absence of an ERISA (3)(38) independent expert, the investment manager of the mutual fund must to agree to assume fiduciary responsibility with respect to the plan's investment in the TDF if it's to qualify as a QDIA. This would put the fiduciary responsibility for the quality of the funds selected for investment, as well as the asset allocation decisions made with respect to a TDF, on the entity actually making those decisions. This is consistent with the sentiment expressed in the preamble to the QDIA regulation:

"[T]he Department continues to believe that when plan fiduciaries are relieved of liability for underlying investment management/allocation decisions, those responsible for the investment management/allocation decisions must be fiduciaries and those fiduciaries must acknowledge their fiduciary responsibility and liability under ERISA ."<sup>2</sup>

---

<sup>2</sup> 72 FR60459 (Oct. 24,2007)



The quoted language is in reference to the required fiduciary status of an investment manager of a TDF QDIA that is not a mutual fund. We believe those same policies are equally applicable when a mutual fund TDF is used as the QDIA. We do not believe there is a policy justification for treating mutual fund TDF's and non-mutual fund TDF's differently in this context. In both cases, a package of funds are put together to achieve a "target date" investment objective. Fiduciary status for the mutual fund TDF investment manager is needed even more because of the conflicting loyalties the fund manager may have due to the existence of the proprietary funds. By requiring a mutual fund TDF to acknowledge, in writing, that it is acting as an ERISA fiduciary, plan sponsors who use mutual fund products will get the same unbiased decision making that TDF's managed by independent ERISA (3)(38) investment managers already receive. We believe this will greatly assist plan sponsors and participants by providing that all TDF managers stand behind the investment decisions they make.

Thank you for your time and attention and I will be happy to answer any questions you might have.